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IN THE

Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-9

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

—v.—

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY,

Respondent.

BRIEF FOR AMICUS CURIAE

STUART B. OPOTOWSKY
ALAN D. BERLIN
277 Park Avenue
New York, New York 10017

WALTER J. ROCKLER
JULIUS M. GREISMAN
RICHARD L. HUBBARD
1229 19th Street, N.W.
Washington, D. C. 20036

Attorneys for Norton Simon, Inc.
Amicus Curiae

Of Counsel:

ARNOLD & PORTER
1229 19th Street, N.W.
Washington, D. C. 20036

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NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY,

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BRIEF FOR AMICUS CURIAE

Question Presented for Review

Whether the issuance of a $50 face amount debenture in exchange for preferred stock of the issuer having a fair market value of $33 resulted in discount on the bond of $17, which is amortizable and deductible by the issuer for federal income tax purposes.

Statutes and Regulations Involved

Contrary to the statement of the government, section 1232 of the Internal Revenue Code of 1954 as amended by the Tax Reform Act of 1969, and section 1.163-3 of the Treasury Regulations as amended in 1968 are not applicable to this case since the case involves a taxable year ending

before these provisions were adopted. The pertinent provisions are section 163 of the Internal Revenue Code of 1954 and section 1.61-12 of the Treasury Regulations as it existed before the 1968 amendment.

Statement of Interest of Amicus Curiae

In July 1968, Norton Simon, Inc. ("Simon") issued $34,518,300 face amount of its six percent Sinking Fund Subordinated Debentures due July 1, 1998, in exchange for Preferred Stock of certain predecessor companies, *i.e.*, Hunt Foods and Industries, Inc. ("Hunt") and Canada Dry Corporation ("Canada Dry"). At the time of the exchange, the Preferred Stock had an aggregate fair market value of $27,066,460. The difference between the face amount of the Simon Debentures and the value of the Preferred Stock exchanged therefor was $7,451,840, and Simon treated this amount as discount on the Debentures, amortizing and deducting a ratable portion of the discount in following years.

These transactions were incident to a Plan of Consolidation, whereby Hunt, Canada Dry, and McCall Corporation were consolidated in July 1968 to form a new corporation, Norton Simon, Inc. The Internal Revenue Service ruled that the consolidation was basically a tax-free reorganization under Internal Revenue Code section 368(a)(1)(A), with exchanges pursuant thereto tax free; however, the exchanges of Hunt and Canada Dry Preferred Stock for Simon Debentures were held to be taxable transactions.

Simon's income tax return for its fiscal year ended June 30, 1969, has been audited by the Internal Revenue Service, and the Service has challenged the amortization and deduc-

tion of discount on the Debentures issued for the Preferred Stock. The matter is at present under administrative review in the Appellate Division of the Internal Revenue Service.

Simon has obtained the written consent of both petitioner and respondent in this case to Simon's filing this Brief for Amicus Curiae. These consents were filed with the Court at the same time this Brief was filed. Simon also filed an Amicus Brief in this case in the Court of Appeals for the Tenth Circuit below.

Statement of the Case

This case involves the review of a decision of the Court of Appeals for the Tenth Circuit in favor of National Alfalfa Dehydrating and Milling Company, the respondent (hereinafter the "taxpayer"), in a federal income tax controversy relating to the taxpayer's fiscal year ended April 30, 1967. Briefly, the taxpayer in July 1957 issued $2,352,950 face amount of five percent sinking fund debentures in exchange for 47,059 shares of its $50 par value preferred stock.[1] At the time of the exchange, the fair market value of the preferred stock was $33 per share, or $1,552,947 in aggregate. The difference between the face amount of the debentures and the fair market value of the preferred stock was $800,003. The taxpayer amortized and ratably deducted, as discount on the issuance of the debentures, portions of this amount in following years.

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[1] At the same time, the taxpayer issued $3 par value common stock in exchange for its outstanding $1 par value common stock, and issued to its preferred shareholders, in lieu of dividend arrearages on the preferred stock, warrants to purchase one-half share of common stock at a price of $10 per share on the basis of one warrant for each share of preferred.

On May 29, 1957, the National Office of the Internal Revenue Service issued a ruling on the taxpayer's proposed transactions, holding that gain or loss would be recognized to the preferred stockholders on the exchange of their preferred stock for the debentures, measured by the difference between the bases of the shareholders in their preferred stock and the fair market value of the bonds issued for the stock. The Internal Revenue Service relied on section 302(a) of the Internal Revenue Code as the basis for its ruling.[2]

On subsequent audit, the Commissioner disallowed the taxpayer's claimed deductions for amortization of discount. The Tax Court upheld the Commissioner's disallowance, but was reversed by the Court of Appeals for the Tenth Circuit, which held the taxpayer's deductions to be proper. See 472 F.2d 796 (10th Cir. 1973), *rev'g*, 57 T.C. 46 (1971).

Summary of the Argument

Where the face amount of a bond exceeds the amount or value received by the issuer for the bond, the excess constitutes discount. Like stated interest on a bond, discount constitutes a cost of borrowing. The issuer of a bond is entitled to amortize and deduct discount as an additional interest cost.

These principles should apply whether the issuer receives cash or some other valuable consideration in exchange for a bond. The cost of borrowing to the issuer is equally

[2] The Service also ruled that no gain or loss would be recognized on the exchange of $1 par value common stock for $3 par value common stock, under Internal Revenue Code sections 368(a)(1)(E) and 354(a).

real whether the corporation has borrowed cash or has incurred an obligation to make a deferred payment for a noncash consideration. For example, a corporation may issue a twenty-year bond with a face amount of $120 at an interest rate of five percent in exchange for $100 cash. The corporation may also issue the same kind of bond in exchange for its own preferred stock with a value of $100. In the taxpayer's view, these cases are economically equivalent. Discount is present in each case and is amortizable and deductible at the rate of $1 per year.

All courts which have considered the issue have held that discount may arise when a corporation issues a bond in order to acquire its own preferred stock. The courts have differed over the measure of such discount, but the better-reasoned view, adopted by the court below, is that discount is measured by reference to the fair market value of the stock at the time of the exchange. When a corporation incurs an obligation to make an outlay in excess of the value it has received, it is this excess, not any other amount, that represents the additional cost of borrowing to the issuer.

All parties to this case reject the view of some courts that discount on a bonds-for-stock exchange should be measured by the excess of the face amount of the bonds over the greater of the amount originally received *for the stock* or the "value of the stock to the corporation." This formulation combines two mutually inconsistent positions, each without merit. The term "value to the corporation" is meaningless in the tax laws unless it refers to fair market value, and the government concedes the concept to be unworkable. Pet. Br. 31. On the other hand, to determine the effective interest cost of issuing a bond for stock in a

current transaction by reference to the amount received for the stock years before in an unrelated transaction would ignore real discount on the current transaction.

Similarly, the government position that discount, a cost of borrowing or adjustment to the stated interest rate, cannot exist where a bond is issued in a nontaxable "recapitalization," or where one "security" is substituted for another, ignores both the nature of discount and the facts of this case. Discount, as a cost of borrowing, has economic reality without regard to the characterization of the borrowing transaction for other purposes. Moreover, the government's arguments have no application to this case since the taxpayer's bonds were issued, not in a nontaxable recapitalization exchange, but in a taxable repurchase of stock. The transaction in this case did not involve the substitution of one "security" for another. The taxpayer's stock was just that—stock, not a "security."

The government's ancillary arguments suffer from the same defects. Whether preferred stock constitutes "property" in the hands of its issuer for some specialized purpose, and whether what is received by a corporation on issuing a bond may be termed "capital," are matters having no relevance to the existence of a cost of borrowing incurred by the issuer to obtain the stock. To suggest that this Court's holding in the *Great Western Power Co.* case[3] is dispositive of this case involves a gross distortion of both this Court's opinion in the *Great Western* case and the facts of this case. To equate the issuance of a $50 bond for $50 cash with the issuance of a $50 bond for stock worth $33

[3] Great Western Power Co. v. Commissioner, 297 U.S. 543 (1936).

simply disregards the record and determined facts in this case.

Finally, Congressional enactments and the legislative history thereof demonstrate Congressional approval of the taxpayer's position and the holding of the court below. Statutory changes made by Congress in 1969 did not reflect any new views on the fundamental nature of discount, but were motivated by the practical policy considerations of discouraging the issuance of debt obligations in corporate reorganizations and providing for ease of administration. The 1969 statutory amendments were made effective prospectively only. The government would now have this Court reverse Congressional action by making the new rules applicable retroactively.

ARGUMENT

I.

The Taxpayer's Bonds Were Issued at a Discount to the Extent That the Face Amount of the Bonds Exceeded the Fair Market Value of the Preferred Stock at the Time of the Exchange.

A. *Discount on the issuance of a bond is amortizable and deductible by the issuer as interest expense.*

It is established beyond question that the excess of the face amount of a bond over the amount received therefor is discount, amortizable and deductible by the issuer of the obligation.[4] The reason for allowing the ratable deduction of discount is plain. Discount represents an expense of borrowing. It serves "the same function as stated interest,"[5] and "must be added to the aggregate coupon payments in order to arrive at the total interest paid."[6]

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[4] Helvering v. Union P.R.R., 293 U.S. 282 (1934); American Smelting & Ref. Co. v. United States, 130 F.2d 883, 885 (3d Cir. 1942). *See also,* H.R. REP. No. 91-413 (Pt. 1), 91st Cong., 1st Sess. 109 (1969), in which the Ways and Means Committee referred to the deduction of original issue discount as a "current interest deduction." The Treasury Regulations have long recognized the deductibility of discount. The Regulations in effect during the taxable year in issue, Regulations section 1.61-12(c)(3), T.D. 6272, 1957-2 CUM. BULL. 18, 32, stated in pertinent part: "If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds." Regulations section 1.61-12(c)(3) was amended in 1968 by T.D. 6984, 1969-1 CUM. BULL. 38, and the pertinent language was carried over in current Treasury Regulations section 1.163-3(a)(1).

[5] United States v. Midland-Ross Corp., 381 U.S. 54, 57 (1965).

[6] Helvering v. Union P.R.R., 293 U.S. 282, 286 (1934).

The government apparently does not contend to the contrary. See Pet. Br. 9-12. Therefore, the only issue in this case is whether there can be discount on the issuance of a bond for valuable consideration other than cash (here, preferred stock).

B. *There may be discount upon the issuance of a bond for property, including stock redeemed thereby.*

Nothing in the applicable statute[7] or the Treasury Regulations[8] suggests that discount may arise only upon the issuance of a bond for cash. Where the consideration received for the issuance of the bond has a measurable, ascertainable value, discount is equally real, and the tax results should be the same as in a cash situation. If the value of the consideration is less than the principal amount of the obligation, there is the same deferred interest cost, in addition to stated interest, as in the case of a bond-for-cash transaction. The majority of courts, including the court below, that have considered the question, have reached this conclusion.[9]

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[7] Int. Rev. Code of 1954, sec. 163. Hereinafter, all references to sections shall, unless otherwise indicated, be to sections of the Internal Revenue Code of 1954.

[8] During the years in issue, Treas. Regs. sec. 1.61-12(c)(3). Since 1968, the same language has been contained in Regulations section 1.163-3(a)(1). *See* note 4 *supra*.

[9] Indeed, the earliest authority supporting this view was a government ruling in O.D. 959, 4 CUM. BULL. 129 (1921), holding that the excess of face amount of mortgage bonds over the fair market value of liberty bonds received therefor represented amortizable discount. While O.D. 959 has been declared obsolete (without explanation) in Revenue Ruling 68-575, 1968-2 CUM. BULL. 603, 605, it was cited favorably as late as Revenue Ruling 57-535, 1957-2 CUM. BULL. 513.

In the case of *American Smelting & Refining Co.* v. *United States,* 130 F.2d 883 (3d Cir. 1942), the taxpayer issued its bonds in exchange for two issues of preferred stock of its subsidiary. With respect to one of the issues, the taxpayer established that the fair market value of the stock (determined by reference to trading on the New York Stock Exchange) was less than the face amount of the bonds, and the court held this difference to be amortizable discount. The government argued that discount could arise only where bonds are issued for cash on the ground that otherwise it would be impossible "to tell whether the loss which the amortization anticipates will ever occur." 130 F.2d at 885. The Court of Appeals, however, rejected this contention. The court first explained the basis for allowing the deduction:

> "It seems to us that the government's argument overlooks what we believe is the rationale of the theory underlying the amortized deduction of discount. Ordinarily, bonds are issued at a discount because the promised rate of interest is, due to the condition of the prevailing market, too low to sell them at par. It would, therefore, seem that the discount allowed is in the nature of additional interest which accrues over the life of the bond and is payable at the maturity of the principal obligation." *Id.*

The court then explained why the government's argument was incorrect:

> "We believe that the discount is still to be treated as additional interest when the subject matter of the loan is stock instead of cash. It is clear in both cases that the discount, or additional interest, is determined at the time the bonds are issued. Thus, when the investor is paid the face amount of the bond at maturity,

> he is taxable for the difference between that sum and the cost of the bond. Here the cost of the bond is the fair market value of the stock at the time the corporate obligations were exchanged. To sustain the government's contention, in view of these considerations, would be to say, in effect, that, on the same loan, the taxable 'interest' earned by the investor varies in amount and is computed as of a different time than the deductible 'interest' paid by the obligor. We think that this not only distorts, unnecessarily, the ordinary incidents of a commercial transaction but also upsets the balance of the tax situation." *Id.* (footnotes omitted).

The *American Smelting* decision was followed in two subsequent District Court cases (in the Fifth and Seventh Circuits, respectively), *Southern Fertilizer & Chemical Co.* v. *Edwards,* 167 F. Supp. 879 (M.D. Ga. 1955), and *Industrial Development Corp.* v. *United States,* 51 A.F.T.R. 1514, 56-2 U.S.T.C. ¶ 10,066 (D. Ill. 1956), both involving the issuance of bonds in exchange for the issuer's preferred stock. The Court of Appeals for the Third Circuit in *Montana Power Co.* v. *United States,* 232 F.2d 541 (3d Cir. 1956), *cert. denied,* 352 U.S. 843 (1956), subsequently reaffirmed its position in the *American Smelting* case.

In the case of *Nassau Lens Co.* v. *Commissioner,* 308 F.2d 39 (2d Cir. 1962), bonds were issued for the assets of a sole proprietorship. The Court of Appeals for the Second Circuit, in an opinion by Judge Marshall which agreed with the reasoning of *American Smelting,* held that amortizable discount could arise upon the issuance of bonds for property other than cash. The court found unpersuasive the argument that there was no discount because it could not be ascertained at the time the bonds were issued whether a subsequent sale of the assets would produce gain or loss:

> "It may well be true that to a 'borrowing buyer' interest or discount payments seem part of the cost of the property. In reality, however, they are the cost of using the money which is needed to purchase the property, a cost not incurred by the buyer with ready cash. . . . The contention asserted is merely that when a seller also becomes a financing medium by taking bonds issued at a discount instead of cash in exchange for property, the tax laws will not recognize a charge for the use of money. We find no support for such an assertion and reject it. See American Smelting & Ref. Co. v. United States, 130 F.2d 883 (3d Cir. 1942)." 308 F.2d at 44 (footnote omitted).

Discount in the case was determined to be the difference between the face amount of the bonds and the fair market value of the assets at the time of the exchange.[10]

The Court of Appeals for the Tenth Circuit, in the case of *Atchison T. & S.F.R.R.* v. *United States,* 443 F.2d 147 (10th Cir. 1971), reached the same conclusion as the courts in *American Smelting* and *Nassau Lens.* In the *Atchison* case, the taxpayer had issued bonds, in the course of a bankruptcy reorganization, for the bonds of its bankrupt predecessor. The court rejected the government's argument that no discount could arise on the issuance of bonds for consideration other than cash. The court found that the pertinent Treasury Regulations under the 1939 Code (which were identical to the Regulations governing this case) did not "distinguish between bonds issued for cash and bonds issued for property." 443 F.2d at 151. To the contrary, the court found that the Regulations recognized

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[10] The Second Circuit Court also decided that an alleged uncertain valuation of the property was "far too thin a reed" to support the Commissioner's contention. 308 F.2d at 44, n. 5.

"*sub silentio* the economic possibility that discount—that is, deferred interest—may be present when bonds are issued in exchange for property as well as for cash" and that such discount arises where "the stated rate of interest on the obligation is less than the rate demanded by the market." *Id.* The court reasoned that its view "conforms with economic and business reality which recognizes that to the issuer bond interest is reflected both by the stated rate of interest and by the amount below or above par received by the issuer when the bonds are originally distributed." *Id.* at 153.

In its opinion below in the present case, the Tenth Circuit Court reaffirmed its holding in the *Atchison* case that discount could exist where a bond was issued for a consideration other than cash, and, in particular, where a corporation issued bonds for its preferred stock. The court, correctly in our view, focused on the principle that discount represents a cost of borrowing, and correctly deemed irrelevant to the question of the cost of borrowing such factors as the character of the consideration or property received upon the issuance of the bond, whether the bonds were issued in a taxable or tax-free transaction, and, where the bonds were issued for preferred stock, the amount historically received by the corporation for the stock in a prior, unrelated transaction. None of these factors has any bearing on the effective interest rate the taxpayer was required to pay in order to acquire its preferred stock on a deferred payment basis.

No court has accepted the view here urged by the government—that there can be no discount when a corporation exchanges its bonds for its preferred stock. The cases discussed above are in agreement that there is discount to the extent that the face amount of bonds exceeds the fair mar-

ket value of the stock. The Court of Claims, certain District Courts, and the Tax Court below in the present case disagree with these decisions as to the measure of discount, but these courts agree that discount can arise upon the issuance of bonds for preferred stock.

C. *Where a corporation issues its bonds in exchange for its preferred stock, discount is measured by the excess of the face amount of the bonds over the fair market value of the stock.*

The Tax Court below held that there was no discount in this case, because it felt that discount should be measured by reference to the amount originally received years earlier by the corporation for the preferred stock. In effect, the Tax Court rejected the current fair market value approach adopted in the cases discussed above, in favor of a position adopted by the Court of Claims.[11]

While the government relied upon the Court of Claims decisions in the Tax Court below, the government's brief before this Court specifically rejects the reasoning of the Court of Claims in these cases. See Pet. Br. 9, 28-34. Even though the government no longer approves of the Court of Claims cases and its brief points out some deficiencies in the reasoning of the Court of Claims, an analysis of the Court of Claims decisions may help to illuminate the issue now before the Court.

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[11] Erie Lackawanna R.R. v. United States, 422 F.2d 425 (Ct. Cl. 1970); Missouri P.R.R. v. United States, 427 F.2d 727 (Ct. Cl. 1970), *modified*, 433 F.2d 1324 (Ct. Cl. 1970), *cert. denied*, 402 U.S. 944 (1971); St. Louis-S.F. Ry. v. United States, 444 F.2d 1102 (Ct. Cl. 1971), *cert. denied*, 404 U.S. 1017 (1972).

In its *Erie* decision,[12] and in its *Missouri Pacific* decision[13] prior to modification, the Court of Claims held that, where bonds are issued in exchange for preferred stock, discount is to be measured by the amount originally received by the corporation for its preferred stock, without reference to the fair market value of the stock acquired. In our view, this approach does not measure real discount. When a corporation issues bonds for its stock, it is the *current* value of the stock that determines the face amount and interest rate of bonds the issuer will issue and the stockholders will accept.

In the present case, the amount the taxpayer was obliged to pay to redeem its preferred stock and the effective interest rate required to defer payment were plainly unrelated to the amount received originally for the stock. The terms of the transaction would have been the same had the preferred stock been originally sold for $5 per share or $100 per share.

The issuing corporation could determine the precise rate of stated interest necessary to issue bonds with a face amount equal to the fair market value of the stock received. Alternatively, the issuer could, as in this case, choose to issue bonds with a face amount greater than the value of the stock but with a lower rate of interest. No one would suggest disallowing any portion of the deduction for stated interest in the first case; there is no more reason to disallow the amortization of discount in the second case. The cases are parallel and economically equivalent, differing in form only. Whether a stockholder had gain or loss on the

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[12] 422 F.2d 425 (Ct. Cl. 1970).

[13] 427 F.2d 727 (Ct. Cl. 1970).

exchange, or whether the corporation economically benefited from the issuance and later redemption of its stock, have nothing to do with the interest or discount expense involved in borrowing, *i.e.*, issuing bonds. Rather, in the making of a loan evidenced by bonds, "discount, or additional interest, is determined *at the time the bonds are issued.*" *American Smelting & Refining Co.* v. *United States,* 130 F.2d 883, 885 (3d Cir. 1942) (emphasis added).

The Court of Claims, in *Erie Lackawanna R.R.* v. *United States,* 422 F.2d 425 (Ct. Cl. 1970), lost sight of these realities in denying a deduction for discount in the following terms:

> "[S]ince plaintiff was exchanging $100 debentures for preferred stock for which it had already received $100 in value, then plaintiff lost nothing as a result of the transaction . . . . The fact that the preferred stock had a market value less than $100 at the time of the exchange is of no consequence in this type of transaction where the plaintiff is purchasing its own stock." 422 F.2d at 429 (footnote omitted).

In effect, the Court of Claims balanced a nontaxable benefit,[14] derived by the corporation from redeeming its preferred stock at less than par, against the discount on a borrowing transaction. We know of no authority, theory, or logic for this result. It would make fully as much

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[14] A corporation does not recognize gain or loss when it issues its own stock for money or otherwise. *See* sec. 1032. Nor does a corporation recognize gain or loss when it redeems its own stock, whether at a lower or higher price than the price at which the stock was issued originally and whether for cash or other property. *See* sec. 311; Treas. Regs. sec. 1.311-1(a). In the Tax Reform Act of 1969, section 311(d) was added to change the rule where a corporation distributes appreciated property in redemption of its stock. Section 311(d) does not apply here.

sense to disallow ordinary stated interest expenses, or indeed any ordinary and necessary business expenses of the corporation, until an offset of the corporation's nontaxable "gain" on repurchasing its preferred stock had been achieved.

The taxpayer in this case would not have been subject to tax if it had redeemed the preferred stock for cash, even though it would, in a sense, have had an economic benefit in the difference between the par value originally received for the preferred stock and the amount paid for the stock on redemption. The result is not different because the preferred stock was redeemed for bonds. The corporate benefit attributable to the stock would likewise in all events be nontaxable. A nontaxable gain in a capital stock transaction simply has nothing to do with the cost of borrowing.[15]

The error was seriously compounded when, shortly after the *Erie* decision, the Court of Claims modified its position in *Missouri P.R.R.* v. *United States,* 427 F.2d 727 (Ct. Cl. 1970), *modified,* 433 F.2d 1325 (Ct. Cl. 1970), *cert. denied,* 402 U.S. 944 (1971). In its original opinion in *Missouri Pacific* (427 F.2d 727), the court had adhered to

[15] The confusion engendered by the Court of Claims view is illustrated in the recent case of Gulf, M. & O.R.R. v. United States, 339 F. Supp. 489 (S.D. Ala. 1972), *supplemental opinion,* 31 A.F.T.R. 2d 73-434 (S.D. Ala. 1972), in which the court adopted the Court of Claims rule and gave as a rationale that a corporation in claiming discount on bonds issued for preferred stock "is attempting to make use of losses which have been borne by its shareholders in the marketplace, thus, in essence, utilizing the loss a second time." 339 F. Supp. at 497. This is an exceedingly strange argument. The gains or losses of shareholders on the exchanges of the stock, measured by their varying tax bases, have nothing whatever to do with the corporation's bond discount.

its holding in *Erie* that discount in a bond-for-stock exchange was measured by the excess, if any, of the face amount of the bonds over the amount originally received for the stock. Shortly thereafter, a District Court in New York,[16] dealing with the same issue, held that discount was to be measured by the excess of the face amount of the bonds over the *greater* of the amount originally received for the stock or "the actual value [of the stock] to the taxpayer."

Stating that it was persuaded by the opinion of the District Court, the Court of Claims modified its original *Missouri Pacific* opinion to adopt the *Cities Service* formulation of the measure of discount.[17] 433 F.2d at 1326. The inference is almost irresistible that the Court of Claims began to realize the troublesome implications of its original position. Under the *Erie* decision, a corporation that issued a $50 bond for a share of preferred stock originally issued for $10 per share, but worth $50 per share at the time of exchange, would be entitled to claim discount of $40 per bond although there was clearly no cost of borrowing other than the stated interest rate. In order to prevent such an unwarranted result, the Court of Claims simply combined its original rule with another, different rule.

To link the "value to the corporation" rule with the "original consideration" rule simply makes no sense; the

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[16] Cities Serv. Co. v. United States, 316 F. Supp. 61, 72 (S.D. N.Y. 1970), *supplemental opinions*, 330 F. Supp. 421 (S.D.N.Y. 1971), 362 F. Supp. 830 (S.D.N.Y. 1973), *gov't appeal to 2d Cir.*

[17] The Court of Claims adhered to this formulation in St. Louis-S.F. Ry. v. United States, 444 F.2d 1102 (Ct. Cl. 1971), *cert. denied*, 404 U.S. 1017 (1972).

two rules are inherently inconsistent. If discount is to be measured by reference to the historical amount received for the stock, then the "value of the stock to the corporation" is irrelevant; if discount is to be measured by reference to the "value of the stock to the corporation," then the historical amount received for the stock is irrelevant. Like the government, "we do not believe that either the issue price of stock or its 'value to the corporation' can contribute a valid measure for the determination of discount upon a recapitalization." Pet. Br. 31.

In its brief, the government makes a half-hearted effort to salvage at least the result that would be reached under the Court of Claims formulation, while rejecting the reasoning on which the result would be based. The government states that "as a matter of simple arithmetic" there can "be no discount when a corporation receives $50 and issues its obligations in the face amount of $50." Pet. Br. 28. Admittedly this is "simple arithmetic," but the statement ignores the patent fact that the taxpayer here did not receive $50 for its $50 bond, but rather received preferred stock worth $33. The $50 originally received for the preferred stock was received in a separate transaction—hardly a part of the repurchase of the stock years later. The receipt of the original $50 had nothing to do with the effective interest rate required to be paid in order to acquire stock worth $33. In short, the "simple arithmetic" applicable to this case is that when a corporation issues a $50 face amount bond and receives therefor consideration worth $33, the bond has been issued at a discount of $17. No amount of verbal juggling can alter this basic, stubborn fact.

It is clear that the government is not serious in its attempt to salvage the Court of Claims formulation because, after repeating its "$50 bond for $50" example of "simple arithmetic," the government asserts that somehow the arithmetic becomes less simple where a $55 bond is issued in exchange for stock for which the corporation had received $50 and that there would not be a discount of $5 in such a case. Pet. Br. 31. In short, the government is comfortable with the Court of Claims rule only as long as the rule produces a denial of discount, but repudiates the rule where it leads to unfavorable results for the government. While we agree with the government that the Court of Claims rule is basically incorrect, we urge that the rule be rejected across the board, not to be resurrected at the government's pleasure.

To summarize, the parties to this case concur that the Court of Claims rule is erroneous and should not be adopted by this Court. In determining discount where a bond is issued for preferred stock, it makes no sense to take into account the amount originally paid in *for the stock.* Bond discount is to be determined at the time the bonds are issued by reference to the value of what was received *for the bonds, i.e.,* the value of the stock. It is immaterial to the question of discount whether, because of other, unrelated tax rules, the issuing corporation has enjoyed a nontaxable economic benefit from the acquisition of its preferred stock.

II.

The Government's Position Consists of Novel Theories Having No Basis in the Statute or Regulations, No Judicial Sanction, and Neither Logic Nor Consistency.

In the judicial history of the issue before the Court, the government has at various times urged, without statutory or regulations basis, that there can be no discount on an exchange of bonds for property,[18] and that discount arises on a bond-for-stock exchange only if the amount originally received for the stock was less than face amount of the bonds.[19] These tenaciously argued, but erroneous, positions have now been abandoned by the government in the present case. In lieu thereof, the government urges that "recapitalization" principles and this Court's decision in the *Great Western Power Co.* case[20] compel a determination that the taxpayer did not issue its bonds at a discount. The present argument of the government is based essentially on redefining "discount," "securities," "obligations," and "recapitalization" to change the established meanings of those terms as they are used in the statute, regulations, and judicial decisions, and on a serious distortion and misapplication of the *Great Western Power Co.* decision of this Court.

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[18] *See, e.g.*, American Smelting & Ref. Co. v. United States, 130 F.2d 883 (3d Cir. 1942).

[19] *See, e.g.*, the opinion of the Tax Court below, 57 T.C. 46, 51 (1971).

[20] Great Western Power Co. v. Commissioner, 297 U. S. 543 (1936).

A. *The government misstates the nature of discount.*

The government attempts to redefine discount in a way that would preclude the existence of discount where bonds are issued in exchange for a corporation's own stock. Thus, the government repeatedly declares that discount can arise only in a transaction by which a corporation acquires "capital."[21] Clearly this is too narrow a concept of discount, advanced only in an attempt to support the government's "recapitalization" theory. Discount is a cost of borrowing generally and may arise whenever a corporation, for *valuable consideration,* incurs a debt. Where a corporation acquires its preferred stock in exchange for bonds payable in the future, it is acquiring something plainly of value in exchange for a promise to pay the purchase price in the future. It incurs a debt to former shareholders in consideration for receiving the stock. Compensation to the shareholders for the right to defer payment may consist of both stated interest and a promise to pay in the future an amount greater than the value of what the corporation received. The latter element is discount; it represents interest to the bondholder for the forbearance of money, and a cost to the bond issuer for the use of money. The cost is real, whether or not what the corporation receives can, for one purpose or another, be termed "capital."

The government argues that in order for discount to exist, "there must be an outlay, or an obligation to make an outlay, in excess of the amount of borrowed capital." Pet. Br. 7. It would be more accurate to say "in excess

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[21] *See, e.g.,* Pet. Br. 7, 14, 17; *cf. id.* at 23-24. In the government's view, a corporation's own stock does not constitute "capital."

of the amount or value received." The government then asserts that in this case "there was neither the requisite outlay nor the obligation" and that there was "no obligation to pay out more than the capital received." *Id.*; see also *id.* at 13-14.

It takes considerable temerity to declare that the taxpayer had no obligation. There is no suggestion in the record that the taxpayer's debentures were not validly issued or did not represent an enforceable claim against the taxpayer. The taxpayer received preferred stock worth $33 and incurred a fixed obligation to pay $50 in the future.

The government continues its misleading analysis by asserting further that the taxpayer "incurred no obligation to pay anything in excess of the amount borrowed." Pet. Br. 14. This assertion makes sense only if it is assumed that the taxpayer somehow "borrowed" $50 when it issued its bonds. In fact, the taxpayer simply received preferred stock worth $33, and the only amount "borrowed" was the amount needed to purchase the stock, *i.e.*, $33.

As authority for its strange analysis, the government cites the opinion of this Court in *Old Mission Portland Cement Co.* v. *Helvering*, 293 U.S. 289 (1934), holding that discount cannot be deducted on a consolidated return with respect to bonds of one member of the consolidated group held by another member of the group, since the anticipated payment of the bonds, upon which the discount deduction is based, would be an "intercompany transaction" not includible in the consolidated return. We fail to understand the relevance of this case. This Court's opinion did not remotely suggest that discount can exist only where a corporation acquires "capital." In fact, this Court stated

that discount arises because, at the maturity of the bonds, "the taxpayer pays the difference, between the amount realized upon the sale of the bonds and their par value." 293 U.S. at 292. In the instant case, the "amount realized upon the sale of the bonds" was $33 per bond, the fair market value of the preferred stock received by the taxpayer. Under the *Old Mission* case, the $17 difference between this amount and the $50 par value of the bonds represents discount.

B. *The government's contention that discount cannot arise where bonds are issued in a nontaxable recapitalization has no basis in authority or logic and is not in any event applicable to this case.*

The basic contention of the government appears to be a rather unfocused argument that no discount can arise with respect to debt obligations issued pursuant to a "recapitalization" described in section 368(a)(1)(E) of the Code. Pet. Br. 24. It is asserted that, since certain exchanges made pursuant to an "E" reorganization do not give rise to taxable *gain or loss* (see section 354), *discount* cannot exist when bonds are issued in an E reorganization, or, if it does exist, it cannot be deducted.

The reorganization provisions, however, do not deal in any way with the existence or deductibility of discount, which is a cost of borrowing and not gain or loss from the receipt or exchange of assets or property. The government appears to suggest, nevertheless, that nonrecognition somehow rubs off on the question of discount on bonds issued in a reorganization. This argument, based on a principle of "nonrecognition by association," not only has no merit, but also is not applicable to this case, where the Internal

Revenue Service has ruled that the bonds were issued in a *taxable* transaction.

Although the issuance of bonds in exchange for preferred stock may in some circumstances arguably constitute a recapitalization within the meaning of section 368(a)(1)(E), it is quite clear that since 1954 this transaction is treated as a redemption of stock under section 302,[22] not as a non-taxable reorganization exchange. In consequence, the shareholder recognizes gain or loss to the extent of the difference between his basis in the stock given up and the fair market value of the bonds received. Example 3 of section 1.354-1(d) of the Treasury Regulations provides:

> "C, a shareholder in Corporation Z (which is not a railroad corporation), surrenders all his stock in Corporation Z in exchange for securities in Corporation Z. Whether or not this exchange is in connection with a recapitalization under section 368(a)(1)(E), section 354 does not apply. See, however, section 302."[23]

The Internal Revenue Service ruling to the taxpayer in this case (reproduced in the opinion of the Tax Court below, 57 T.C. at 48, n. 3) conformed to this Regulation.

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[22] *I.e.*, assuming no dividend equivalence, the acquisition of the stock is treated "as a distribution in part or full payment in exchange for the stock." Sec. 302(a)

[23] Section 354 cannot apply to such an exchange because the section does not apply where securities are received and no securities are surrendered. Sec. 354(a)(2)(B). It is significant that prior to the enactment of this provision in 1954, the government had consistently taken the position in litigation that the issuance of bonds for stock constituted a (taxable) redemption rather than a (nontaxable) recapitalization. *See, e.g.*, Alan O. Hickok, 32 T.C. 80 (1959), *nonacq.*, 1959-2 CUM. BULL. 8; Wolf Envelope Co., 17 T.C. 471 (1951), *nonacq.*, 1952-1 CUM. BULL. 6; Clarence J. Schoo, 47 B.T.A. 459 (1942), *nonacq.*, 1942-2 CUM. BULL. 31.

The ruling stated that, assuming the bonds qualified as bona fide debt obligations, gain or loss would be recognized to the preferred shareholders under section 302(a).[24] Consequently, there was nothing tax-free about the issuance of the taxpayer's bonds that could "rub off" on the issue of discount.

Even in a tax-free situation, the government's recapitalization theory is unsound. Since discount represents simply a cost of borrowing, it may exist whenever there is a borrowing regardless of the nature of the transaction in which the borrowing occurs. There is no reason to treat discount differently from stated interest on a corporate bond; stated interest is deductible by the corporation re-

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[24] The government's brief ignores the ruling received by the taxpayer except for one reference in a footnote. Pet. Br. 16, n. 14. The government there asserts that, because the ruling held that the preferred shareholders had capital gain or loss from the receipt of the debentures, "the ruling necessarily indicated that no discount resulted to the corporation since discount to the corporation would have produced equivalent ordinary income to the recipients of the debentures." This statement is misleading in several ways. First, the ruling was issued on May 29, 1957, at a time when section 1232 provided that original issue discount would not constitute taxable income to the holder of a bond until the sale or exchange of the bond. It is not surprising, therefore, that the ruling did not purport to deal with future tax results from the sale or exchange of the bonds that might take place in later years. The government could equally argue that the stated interest paid on the bonds is not deductible by the taxpayer since the ruling did not state that such interest would be income to the bondholders.

Second, the ruling in no way negatived discount. It stated that the shareholders would recognize gain or loss based on the fair market value of the debentures received and that the basis of the debentures to the shareholders would be that fair market value. Any excess of the face amount of the bonds over the basis of the bonds (fair market value at the time of the exchange) would, of course, constitute original issue discount. *See* sec. 1232(b), as it existed in 1957. The assertion in the footnote, therefore, is erroneous.

gardless of whether the bond is issued in a recapitalization or in any other transaction, taxable or nontaxable.[25]

This view has been reflected in virtually every decision to consider the question of discount on bonds issued other than for cash, even though the courts have differed on other aspects of discount. Thus, the Court of Claims, in its initial opinion in *Missouri Pacific R.R.* v. *United States*, 427 F.2d 727 (Ct. Cl. 1970), reviewed what meager authority it could find on the effect of a reorganization on discount,[26] and concluded:

> "Despite this authority, which is not exactly overwhelming in its strength or particularly persuasive in its approach, we find that bond discount can arise where there is a difference between what is given up and what is received, and this can occur in connection with a corporate reorganization." 427 F.2d at 733.

Other courts that have adopted the Court of Claims approach in the case of bonds issued for stock have also failed to find any significance in whether or not the bonds

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[25] *Cf.* Treas. Regs. secs. 1.483-1(b)(1) and (6) Ex. (7), where for the purpose of determining interest on deferred payments under Code section 483, the government has made it clear that there may be an unstated interest factor in a reorganization exchange. *See also*, Regs. sec. 1.483-1(b)(6), Ex. (4), providing that there may be unstated interest on the redemption of stock through the issuance of an obligation.

[26] The only authority the court could find was Revenue Ruling 59-387, 1959-2 CUM. BULL. 56, certain dictum concurred in by only two of the seven judges of the Third Circuit in Montana Power Co. v. United States, 232 F.2d 541 (3d Cir. 1956), *cert. denied*, 352 U.S. 842 (1956), and an old Board of Tax Appeals opinion in New York, C. & St. L. R.R., 23 B.T.A. 177 (1931), *aff'd*, 64 F.2d 152 (D.C. Cir. 1933). Examination of these two court opinions does not reveal any real support for the government's theory.

were issued in a tax-free transaction. See *Gulf M.&O. R.R.* v. *United States,* 339 F. Supp. 489 (S.D. Ala. 1972), *supplemental opinion,* 31 A.F.T.R.2d 73-434 (S.D. Ala. 1972); *Cities Service Co.* v. *United States,* 316 F. Supp. 61 (S.D.N.Y. 1970), *supplemental opinions,* 330 F. Supp. 421 (S.D.N.Y. 1971), 362 F. Supp. 830 (S.D.N.Y. 1973), *gov't appeal to 2d Cir.*

In *Industrial Development Corp.* v. *United States,* 51 A.F.T.R. 1514, 56-2 U.S.T.C. ¶ 10,066 (D. Ill. 1956), the court found that amortizable discount was created upon the issuance of debentures for preferred stock in a transaction the Internal Revenue Service had ruled to be a tax-free recapitalization:

> "The fact that the debentures were issued in connection with a tax-free recapitalization resulting in the recognition of no gain or loss to the recipient of the debentures, does not deprive the Plaintiff of its right to amortize and deduct the discount over the life of the debentures." 51 A.F.T.R. at 1518, 56-2 U.S.T.C. at 56,804.

See also *Southern Fertilizer & Chemical Co.* v. *Edwards,* 167 F. Supp. 879 (M.D. Ga. 1955), where the court reached the same conclusion in the case of bonds issued for preferred stock in a recapitalization. Similarly, the court in *Nassau Lens Co.* v. *Commissioner,* 308 F.2d 39 (2d Cir. 1962), found that there was discount in the issuance of bonds for tangible assets in a tax-free exchange under section 351.

In short, many courts have considered the question of discount on bonds issued in tax-free reorganizations, but

no court, as far as we are aware, has based its conclusion on whether the bonds were issued in a taxable or tax-free transaction. The government, however, continues to urge its recapitalization argument without statutory or judicial authority, in a case where the transaction was not tax-free.

The only hint, at best, of support for the government's position is contained in its own pronouncement in Revenue Ruling 59-387, 1959-2 CUM. BULL. 56. A careful reading of this Revenue Ruling reveals that even it fails to assist the government. The ruling dealt with a corporation that had issued bonds and common stock for its outstanding preferred stock, and held that the excess of the aggregate *fair market values* of the bonds and common stock over the fair market value of the preferred stock did not constitute discount. The taxpayer here does not contend that discount is computed by reference to the fair market value of the bonds issued but rather that the relevant measure is the *face amount* of the bonds. Since discount is premised on the obligation of the issuer to pay an amount greater than the value of what it received, and since the obligation of the issuer is to pay the face amount of the bonds, it is the excess of the face amount, not the fair market value of the bonds, over the value received that constitutes the measure of discount. Revenue Ruling 59-387 simply disapproves of a discount theory which is not advocated by any party in this case and which does not appear to have been advocated in any other reported case.

C. *The government's reliance upon cases involving exchanges of securities is misplaced; these cases do not deal with the existence and measure of discount, and the present case does not involve an exchange of securities.*

The government repeatedly characterizes this case as one in which the taxpayer substituted one issue of "securities" for another issue of "securities", and repeatedly asserts that the substitution of one security for another cannot produce deductible bond discount. See Pet. Br. 8, 9, 14, 16, 24, 27, 29. As with its statements that discount cannot arise in a "recapitalization" and that discount can arise only where a corporation acquires "new capital," the government appears to believe that sheer repetition of the statement "the substitution of securities cannot produce discount" will dispense with the need for analysis.

The term "securities" in the tax laws is, like the term "recapitalization," a specifically defined term which is not used in some vague generic sense. In the cases cited by the government and in Subchapter C of the Code generally dealing with the taxation of corporate transactions, the term "security" refers to a debt obligation issued by a corporation, and does not apply to an equity or proprietary interest such as preferred stock. See, *e.g.*, Code secs. 354 and 356, which refer to "principal amount" of "securities,"[27] as distinguished from "stock."

The instant case involves bonds (*i.e.*, debt obligations to pay fixed sums at a future date) issued in redemption of preferred stock. Preferred stock cannot be considered a "security" within the context of authorities cited by the

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[27] *See also*, Rev. Rul. 59-98, 1959-1 CUM. BULL. 76; Griswold, *"Securities" and "Continuity of Interest,"* 58 HARV. L. REV. 705 (1945).

government. Consequently, it is seriously misleading to refer to this case as one involving the substitution of one issue of securities for another.

The government goes to some length in an attempt to show that the taxpayer's bonds were virtually identical to its preferred stock (Pet. Br. 14-15), stating that the exchange of bonds for preferred stock "had no major investment significance either to [the taxpayer] or to its preferred shareholders." It may be true that from a broad economic and investment point of view the distinction between corporate debt obligations and preferred stock may sometimes be less important than their similarities. However, the distinction between debt and stock can hardly be ignored in a court of law and is particularly important in the tax laws.[28] The test is not one of "investment signifi-

[28] Some of the more important tax consequences of the distinction may be noted: Interest paid on debt is deductible (Code sec. 163), while dividends paid are generally not. Interest received by a bondholder is fully taxable as ordinary income (Code sec. 61 (a)(4)), while distributions received by a stockholder may not be under some circumstances (Code secs. 301(c), 316). Dividends up to $100 received by an individual are excluded from gross income (Code sec. 116), while there is no such exclusion for interest. Intercorporate dividends result in a deduction for the recipient (Code sec. 243), while there is no such deduction for the recipient of intercorporate interest. The treatment of the holder of a worthless debt obligation may differ from that of the holder of worthless stock. Compare Code secs. 165(g) and 166. Gain on the retirement of a debt obligation may be treated differently from gain on the redemption of stock. Compare Code secs. 302 and 1232. The distinction is crucial in the "continuity of interest" test devised by this Court in the case of corporate reorganizations. *See* LeTulle v. Scofield, 308 U.S. 415 (1940). Section 385 of the Code, added by section 415(a) of the Tax Reform Act of 1969, empowers the Treasury to promulgate "such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for purposes of this title as stock or indebtedness." Sec. 385(a). For an exhaustive study of the topic, *see* Plumb, *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369 (1971).

cance." There have been literally hundreds of cases in which the courts have had to determine whether a particular interest in a corporation represented a stock interest or a true debt obligation for tax purposes.[29]

The government's attempt to demonstrate the similarity between the taxpayer's bonds and its preferred stock, and the contention that, to the extent an exchange took place, it benefited the corporation (Pet. Br. 14-15),[30] are simply irrelevant to this case. There is no contention by the government that the taxpayer's bonds did not constitute valid debt obligations or that they should be treated as an

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[29] *See, e.g.*, this Court's opinion in John Kelley Co. v. Commissioner, 326 U.S. 521 (1946). *See also* the cases cited in Plumb, *supra* note 28.

[30] It is interesting to compare the government's analysis with that of the District Court in Gulf M.&O. R.R. v. United States, 339 F. Supp. 489, 497 (S.D. Ala. 1972), involving an exchange similar to the one here in question:

> "This court is convinced that an exchange of a corporation's income debentures for its outstanding preferred stock is more than a 'mere reshuffling of assets.' Instead, a very basic transformation has occurred in the capital structure of the corporation. A creditor, with full rights, has been substituted for what had previously been one with owner interest in the company. An obligation to pay the face amount of the debentures plus the interest rate has been created from what once was a discretionary power depending only upon earnings and the good faith of management. Also, from the corporation's standpoint, a deductible yearly expense has been substituted for non-deductible dividend payments."

The government goes far afield in suggesting that the existence of discount, a cost of borrowing, is determined by an analysis of whether the borrowing transaction as a whole produced a benefit or burden to the issuer or its bondholders. Presumably, every corporate borrowing is undertaken with the object of producing some type of benefit, but surely such intent has nothing to do with the measure of the effective interest rate of the borrowing or the deductibility of discount.

equity interest for tax purposes; conversely, there is no contention by the government that the taxpayer's preferred stock should be treated as debt for tax purposes.[31] Regardless of broad economic similarities, the bonds and the preferred stock must be treated for tax purposes as distinct types of legal interests, and the issuance of the bonds in exchange for the preferred stock cannot be regarded as the substitution of one issue of securities for another (*i.e.*, the substitution of one issue of debt obligation for another).[32]

The government also relies on the recent case of *Claussen's, Inc.* v. *United States*, 469 F.2d 340 (5th Cir. 1972), as authority for its "substitution of securities" argument. Pet. Br. 16-17. The *Claussen's* case, however, dealt with a situation altogether different from this case. The taxpayer in *Claussen's* issued to its common shareholders, on a pro rata basis, bonds and new common stock, so that after the exchange the shareholders retained the same proportionate proprietary interests in the corporation they had prior to the exchange. In addition, they received bonds. The Court of Appeals held that no discount was created in this transaction since the shareholders gave up nothing of value which the corporation received for the issuance of

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[31] *See, e.g.*, the government's arguments in Ragland Inv. Co., 52 T.C. 867 (1969), *aff'd per curiam*, 435 F.2d 118 (6th Cir. 1970); Zilkha & Sons, Inc., 52 T.C. 607 (1969), *acq.*, 1970-1 CUM. BULL. xvi.

[32] Otherwise, the ruling of the Internal Revenue Service in this case—that the exchange of bonds for stock was taxable—which has not been challenged by any party, would be seriously questionable. *Cf.* Commissioner v. Neustadt's Trust, 131 F.2d 528 (2d Cir. 1942); Rev. Rul. 58-546, 1958-2 CUM. BULL. 143.

the bonds; in short, there was no borrowing upon which discount could arise. 469 F.2d at 344.[23]

Unlike the transaction in the *Claussen's* case, the taxpayer's preferred shareholders here did not retain the stock interests they exchanged and, therefore, did not retain a ratable equity interest in the company. Where a corporation redeems preferred stock that is not held ratably to common stock, the preferred stockholders are exchanging something of value; a cost of borrowing may be incurred in the form of discount if the corporation, in exchange for the stock, promises to pay in the future an amount of money greater than the value of the stock.

The government invokes this Court's decision in *Great Western Power Co.* v. *Commissioner,* 297 U.S. 543 (1936), declaring that the *Great Western* case is "directly contrary" to the decision of the court below (Pet. Br. 8), and that the court below improperly "disregarded" the *Great Western* decision (Pet. Br. 27). The government further characterizes the *Great Western* case as holding that "for purposes of determining the existence and amount of discount upon the substitution or exchange of one issue of securities

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[23] The court stated, "In other words bond discount might properly be incurred, in economic terms, in a transaction involving some form of borrowing by the corporation at a cost to it of something more than the coupon rate of interest, or conversely in the situation where something of real value to the corporation is surrendered in exchange for its new bonds. . . . Immediately after recapitalization the original shareholders owned substantially the same equity interest in the corporation as they had held before and thus their prior rights of ownership were preserved intact. This being so, the old shareholders surrendered nothing of value to the corporation [citation omitted], and as a consequence there was no 'borrowing' sufficient to give rise to bond discount." *Id.* (footnotes omitted).

for another, the transaction must be viewed as a continuum." *Id.* Aside from the fact that the present case, as discussed above, does not involve the substitution of one issue of securities for another, the government's description of the holding of *Great Western* is pure distortion.

If the *Great Western* case held what the government claims it does, it might be expected that the case would have played a major role in the numerous decisions discussed above involving the questions of the existence and measure of discount on bonds issued for bonds or stock. A review of the cases involving this issue, however, reveals that *Great Western* has never been cited, much less relied upon, by any court. Indeed, the government's brief before the Tax Court in this case failed to cite the *Great Western* case, and the government's brief before the Court of Appeals in this case referred to the *Great Western* case simply as a "related decision." Only now has the *Great Western* case become a "contrary" decision.

The *Great Western* case has received no attention in the decisions of the courts considering the present issue because that case has no bearing on the issue. In the *Great Western* case, the taxpayer issued at a discount certain bonds under an indenture providing that the holders had the option, if the taxpayer called the bonds, to elect to receive new bonds equal in face amount to the old bonds, plus an amount of cash, in lieu of receiving the face amount of the old bonds. The taxpayer called the old bonds, and some bondholders elected to receive new bonds plus cash. The taxpayer attempted to use the issuance of the new bonds pursuant to this option as an occasion for deducting unamortized discount on the old bonds. This Court denied

the deduction. The decision holds that, where the holder of a bond exercises his option to substitute a new bond for the old and where the bonds are of equal face value, the issuance of the new bonds is not to be considered as a payment of the old bonds that would permit the deduction of unamortized discount on the old bonds; the unamortized discount on the old bonds must instead be amortized over the life of the new bonds.

The *Great Western* case did not present the question whether discount arose on the substitution of the new bonds and cash for the old bonds. There is nothing in this Court's opinion or in the opinions of the lower courts[34] in *Great Western* to indicate the fair market value of the old bonds, and there is no indication that such fair market value was less than the face amount of the new bonds plus the cash received by the bondholders. The *Great Western* case dealt with the proper treatment of discount created on the original issue of old bonds that were later replaced by new bonds; in the present case, new bonds were exchanged for outstanding preferred stock, upon whose issuance, of course, no discount arose or could have arisen.

The court below concluded that the tax consequences in this case, where bonds were issued for preferred stock, should be the same as in a case where a corporation issues bonds at a discount for cash and uses the cash to redeem preferred stock. The government argues that an analysis based on "such a division of [the taxpayer's] unified transaction into the suggested non-existent hypothetical components" is improper, citing *Great Western*. Pet. Br. 26.

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[34] 79 F.2d 94 (2d Cir. 1935), *rev'g*, 30 B.T.A. 503 (1934).

In this statement, the government misconceives the import of the reasoning of the court below. The court below did not indicate that the transaction in the instant case should be broken down into two transactions for tax purposes, but simply stated that the tax consequences of the actual transaction here involved (the issuance of bonds for preferred stock) were the same consequences that would result if bonds were issued at a discount for cash and the cash used to redeem preferred stock.

This Court held in the *Great Western* case that the conversion of one bond according to its terms into another bond of equal face amount did not produce the same tax consequences that would have resulted from issuing new bonds for cash and using the cash to retire the old bonds. In substituting one bond for another the corporation had not made the outlay upon which the deduction of unamortized discount is premised. In the present case the taxpayer, by issuing a $50 bond for stock worth $33, incurred the same obligation to make an outlay in excess of the value of what it received that it would have incurred had it issued the $50 bond for $33 cash.

D. *The government's equation of the transaction in this case with a redemption of the preferred stock for $50 cash is contrary to the record.*

After declaring that it is improper to restructure the transaction, the government offers its own analysis based on comparing different transactions. It asserts that, since the taxpayer would have incurred no discount expense if it had redeemed its shares for $50 cash per share, the substitution of a $50 bond cannot produce a deduction for discount. Pet. Br. 7, 18-19, 32-34.

To support this conclusion, the government hints that the issuance of the taxpayer's bonds for its preferred stock was accomplished pursuant to the redemption provisions applicable to the preferred stock, pointing to provisions in the taxpayer's certificate of incorporation and the preferred stock certificates giving the taxpayer the power after December 1, 1955, to redeem the preferred shares at a price of $51 per share as long as there were no dividend arrearages. Pet. Br. 18. The actual transaction in this case, of course, was not undertaken pursuant to these redemption provisions, but was undertaken pursuant to a new plan that required the approval of the taxpayer's shareholders.[35]

The government correctly observes that a corporation recognizes no gain or loss when it redeems its own shares for cash. See sec. 311. The government then asks, in light of this fact, how discount can arise where stock is redeemed for a bond. As the government is well aware, the discount claimed by the taxpayer in this case is based on the issuance of the taxpayer's obligation to pay an amount greater than that received by the taxpayer for the issuance of the obligation; the taxpayer's claim is not that it suffered a loss by acquiring its preferred stock. Consequently, the cases and Code sections cited by the government (Pet. Br. 18) are wholly irrelevant.

The government's analogy of the issuance of a $50 bond to a $50 cash payment may be intended to suggest that the taxpayer's preferred stock had a fair market value of $50

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[35] A similar attempt to recast the facts of the case was made by the government, and rejected by the court, in Cities Serv. Co. v. United States, 316 F. Supp. 61, 66-69 (S.D.N.Y. 1970).

per share at the time of the exchange. If so, the suggestion is entirely unsupported by anything in the record. Rather, the court below reached its conclusions upon the basis that the taxpayer's preferred stock was worth $33 per share. See, 472 F.2d at 797, 800, 801, 802, 804. The government did not apply to this Court for *certiorari* on the ground that the preferred stock was worth more than $33 per share, and assuredly the writ was not granted by the Court to review the valuation of the preferred stock.

E. *Whether the taxpayer's preferred stock constituted "property" in some specialized technical sense has no relevance to the issue presented in this case; the stock was valuable consideration received by the taxpayer for its bonds.*

The government asserts that a corporation's repurchase of its own preferred stock does not constitute the acquisition of an "asset," and that such preferred stock in the hands of the corporation is not considered "property" for certain tax purposes. Pet. Br. 8, 23-26. From this, the government concludes that cases involving the exchange of bonds for "property" are not here relevant. Although intimating that the preferred stock is a kind of nullity, the government would doubtless admit that in the hands of the shareholders the preferred stock did constitute "property," so that it is not entirely accurate to describe the issuance of bonds for preferred stock as the issuance of bonds for some form of nothing or "non-property."

We need not pursue these niceties since questions of the existence and measure of discount in the instant case do not depend upon whether the taxpayer's preferred stock constituted "property" in a special sense for special

purposes.[36] What is significant is that the corporation received for its bonds valuable consideration of a value less than the face amount of the bonds. This case is not like the *Claussen's* case, where bonds were simply distributed pro rata to shareholders. The taxpayer did not issue bonds to its preferred shareholders as a dividend or as a gift. The taxpayer obtained stock worth $33 a share in the over-the-counter market in exchange for its promise to pay $50 in the future. The $17 difference represents a cost of borrowing—a cost that was real and that was incurred irrespective of any label which may be applied to the consideration received by the taxpayer.

The defects in the government's "property" argument are the same as the defects in its "capital," "recapitalization," and "substitution of securities" arguments and may be seen readily in a simple illustration. Suppose a corporation wishes to acquire two items, a depreciable asset and a block of its own preferred stock, each with a market value of $1,000. Suppose further that the corporation finances its purchases by borrowing and issuing bonds. This borrowing may take either of two forms: the corporation may give its one-year bond bearing nine percent interest with a face amount of $2,000, or it may give its one-year bond bearing four percent interest with a face amount of approximately $2,100. In the latter case, the amount of $100 is clearly discount, an added cost of borrowing. This is so regardless of the nature of the assets acquired with the $2,000 proceeds.

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[36] Under Code section 317(a), to which the government refers (Pet. Br. 24), the term "property" does not include stock in the distributing corporation for purposes of the sections of the Code dealing with corporate distributions on stock (sections 301-317). This special definition has no application to any provision of the Code relating to interest or discount. *Cf.* sec. 1232(b)(2).

The result should be the same if the acquisitions are financed through the sellers of the property. To illustrate, the corporation could give the seller of the depreciable asset its one-year bond bearing nine percent interest with a face amount of $1,000, or its one-year bond bearing four percent interest with a face amount of approximately $1,050. Clearly, in the latter case, there would be discount of $50. Similarly, the corporation could give the seller of the preferred stock either of the two bonds. In the case of the four percent $1,050 bond, there would be discount of $50; the existence and measure of this discount would in no way be affected by whether the preferred stock were considered "property" or an "asset," by whether the transaction were considered to be the acquisition of new "capital," or by whether the transaction were considered to be a "recapitalization" or the "substitution of one security for another." Yet the government in effect argues that, although the two four percent bonds, one issued to the seller of the depreciable asset and the other to the seller of the preferred stock, are in all respects identical, discount would exist only with respect to the bond given to the seller of the depreciable asset. Such a conclusion is wholly illogical and, we believe, insupportable.

In short, where a corporation issues its bonds for valuable consideration, it is in effect borrowing an amount equal to the fair market value of what it receives. If it binds itself to pay back in the future more than it receives at issuance, there is discount on the bond. This is the economic reality.

III.

The Decision of the Court Below Is Also Supported by the Amendments to Section 1232(b)(2) of the Code Made by the Tax Reform Act of 1969.

Up to this point, we have considered what the courts have said about bond discount, and analyzed the logic and implications of the government's arguments. We believe it also worthwhile to examine the enactments and stated purposes of the Congress in this area.

In the Tax Reform Act of 1969, Congress amended section 1232 of the Code, dealing with the treatment of original issue discount by bondholders. The primary purpose and effect of the amendments was to achieve consistency in treatment between issuers and holders in the reporting of discount: holders were required to report discount income ratably, just as issuers had always ratably amortized discount expense.

The 1969 changes arose at the instance of the Treasury, which made the following proposal:

> "Present concern is also expressed about transactions in which debt is a significant element of the acquisition price. Tax policy should focus on the appropriateness of the interest deduction with respect to the issued debt. It appears, however, that the greatly increased use of debt in recent acquisitions is motivated primarily by factors other than the desire to obtain an interest deduction for tax purposes. . . .
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> ". . . [W]e propose that the following immediate steps be taken by legislative action. These steps will

impede mergers and acquisitions in which debt securities are used to gain tax advantages . . . .

. . . .

"(2) To achieve consistency of treatment between bondholders and the issuing company where bonds are issued at a discount, we recommend that Section 1232 be amended to require that original issue discount be treated as additional interest income to the bondholders to be reported ratably over the life of the bonds." REPRESENTATIVES OF THE TREASURY DEPARTMENT, TAX REFORM PROPOSALS CONTAINED IN THE MESSAGE FROM THE PRESIDENT OF APRIL 21, 1969, PRESENTED TO THE COMM. ON WAYS AND MEANS, 91st Cong., 1st Sess. 47-49 (Comm. Print 1969).

The Treasury recognized that a corporation could amortize and deduct discount with respect to bonds issued in tax-free reorganizations for stock or other assets. The Treasury did not propose to alter that treatment. It only proposed that the bondholders' treatment be made consistent.

The Ways and Means Committee in turn expressed concern about the conglomerate problem and its relation to debt-financed acquisitions:

"There are also provisions of the tax laws which your committee believes provide an inducement to the use of debt in corporate acquisitions and, accordingly, act as a stimulant, generally, to merger activity. These provisions include . . . (3) *the rules governing original issue discount which permit the interest element to be ratably deducted by the acquiring corporation, but which is not ratably reported, by the debenture owner.*" H.R. REP. No. 91-413 (Pt. 1), 91st Cong., 1st Sess. 103 (1969) (emphasis added).

Thus, the Ways and Means Committee recognized, as did the Treasury, that the issuing corporation could amortize

and deduct original issue discount in a merger acquisition (*i.e.*, a tax-free reorganization). The Committee was not disturbed by the corporation's deduction, but was concerned with the failure of the debenture-owner ratably to report discount income.

As passed by the House and as reported by the Senate Finance Committee, section 413 of the Act contained the following addition to section 1232(b)(2) of the Code:

> "In the case of a bond or other evidence of indebtedness, or an investment unit as described in this paragraph, issued for property, the issue price of such bond or other evidence of indebtedness or investment unit, as the case may be, shall be the fair market value of such property."

This provision, of course, expressed the rule of the *American Smelting, Nassau Lens,* and *Atchison* cases—that discount could arise from the issuance of bonds for property, and that the measure of discount was the fair market value of the property received.

In explaining this provision, the House Ways and Means Committee observed:

> "There is some question under present law as to whether the original issue discount rule applies to a bond which is issued for property, *such as stock,* which has a value below the face amount of the bond.
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> . . . .
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> "In order to *clarify* the situations in which original issue discount may arise, the bill further provides that there may be original issue discount when a corporation issues a bond for a price less than its face value whether it receives cash, *stock,* or other property (including the assets of another corporation) for the

bond." H.R. REP. No. 91-413 (Pt. 1), 91st Cong., 1st Sess. 109-110 (1969) (emphasis added).

The clarification presumably intended was to provide expressly what the Treasury and the Ways and Means Committee assumed was the sound existing law—that the issuing corporation could deduct and amortize bond discount on bonds issued for property, including stock, and to make the debenture holder's treatment of original issue discount consistent.[37]

The Senate Finance Committee approved the House proposal to clarify the situation in which original issue discount may arise when bonds or evidence of indebtedness are issued for property. S. REP. No. 91-522, 91st Cong., 1st Sess. 146-148 (1969). The Staff of the Joint Congressional Committee noted that "[t]he bill also clarifies present law by providing that original issue discount may arise when a bond is issued in exchange for stock or other property." STAFFS OF JOINT COMM. ON INTERNAL REVENUE TAXATION & COMM. OF FINANCE, 91st Cong., 1st Sess., SUMMARY OF H.R. 13270, THE TAX REFORM ACT OF 1969 (AS PASSED BY THE HOUSE OF REPRESENTATIVES) 61 (Comm. Print 1969).[38]

At the last-minute suggestion of the Treasury, the bill was thereafter modified on the floor of the Senate in two

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[37] A clarification of existing law by a Committee report is entitled to great respect. *Cf.* Commissioner v. Bilder, 369 U.S. 499 (1962).

[38] In the case of Missouri P.R.R. v. United States, 427 F.2d 727 (Ct. Cl. 1970), the Court of Claims dismissed (at 731, n. 7) the significance of this legislative history as not "detrimental" to its decision. Obviously, however, the Treasury, Congressional, and Staff actions and statements are completely inconsistent with the Court of Claims view.

respects: (1) the issue price determined on the basis of the fair market value of the property was limited to situations where either the bonds are traded on an established securities market or the property consists of securities so traded; (2) the definition of issue price was revised so that, in the case of a bond or evidence of indebtedness issued pursuant to a plan of reorganization, the issue price is deemed to be the stated redemption price at maturity.

These changes were explained in a letter from John S. Nolan, Deputy Assistant Secretary of the Treasury, to Senator Williams. Mr. Nolan stated that the first limitation was to prevent a whip-saw effect for the Treasury, which could occur if the bond issuer and the bondholder valued the property transferred to the corporation differently. This could not arise if the values were determined on an established securities exchange. Mr. Nolan explained the new exclusion for reorganization exchanges as follows:

> "The reorganization problem arises because in a tax-free reorganization, no gain or loss is recognized to the corporations involved and the basis of the assets of the transferor corporation carries over, that is, such assets have the same basis in the hands of the transferee corporation. Under these circumstances, original issue discount should not be taken into account so as to give the transferee corporation an amortization deduction as a result of the issuance of its bonds in the reorganization. In other situations, the issuing corporation pays a price where there is original issue discount because the basis of the assets is their lower value at the time the bonds are issued rather than the face amount of the bonds. In a reorganization, however, where the basis of the assets carries over, this 'leveling' factor does not exist and there is every reason for the issuing corporation to claim a low value for the assets to

increase its amortization deduction for bond discount if such a deduction is allowed." 115 CONG. REC. 36730 (1969).[39]

In any event, the changes suggested by the Treasury and made on the floor of the Senate were applicable prospectively only, to bonds or evidence of indebtedness issued after May 27, 1969. They did not retroactively change what the Congressional Committees and the Treasury viewed as the proper pre-existing law.

In essence, the government's argument to this Court urges the Court to pronounce retroactively a new rule that Congress has made prospective only from the middle of 1969 on. The new Congressional rule was not represented to be a restatement of prior law; Congress regarded the prior law as determined by the various Courts of Appeals, including the Court of Appeals below, to be sound. Congress merely responded to a last-minute Treasury appeal, on limited practical policy grounds, to change the law for the future. The 1969 legislation and legislative history thus strongly support the decision of the court below.

[39] The Treasury saw problems in bonds issued to acquire assets because of valuation uncertainties where depreciable assets are the consideration. These problems do not exist in any form in the case now before this Court. In the instant case, the preferred stock had a readily ascertainable value by virtue of being traded over the counter.

CONCLUSION

For the reasons stated above, the judgment of the Court of Appeals should be affirmed.

Respectfully submitted,

STUART B. OPOTOWSKY
ALAN D. BERLIN
277 Park Avenue
New York, New York 10017

WALTER J. ROCKLER
JULIUS M. GREISMAN
RICHARD L. HUBBARD
1229—19th Street, N.W.
Washington, D. C. 20036

Attorneys for Norton Simon, Inc. Amicus Curiae

Of Counsel:

ARNOLD & PORTER
1229—19th Street, N.W.
Washington, D. C. 20036